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SUBJECT: PAKISTAN'S FISCAL DEFICIT PUTTING ECONOMIC STABILITY AT RISK

Summary

11. (SBU) Summary: The IMF expects the fiscal deficit for the current fiscal year to be as high as 6.5 percent of GDP, far exceeding the 4 percent target. A nearly \$1 billion shortfall in tax collection, larger than budgeted expenditures, below target privatization receipts, and the projectization of the \$200 million in U.S. budget support are responsible for the above target budget deficit. Deficit financing options are limited, and the GOP has resorted to excessive borrowing from the Central Bank to finance the growing budget gap. This is fuelling inflationary pressures with July-January inflation at 8.6 percent, compared to the 6.5 percent target. As a result, the incoming government will need to make difficult choices to preserve macroeconomic stability. End summary.

GOP will miss fiscal deficit target

12. (SBU) The GOP will miss its 4 percent fiscal deficit target by a large margin. According to the IMF, the fiscal deficit will be 6.5 percent of GDP for the current fiscal year, compared to the current fiscal year target of 4 percent of GDP. The shortfall is estimated at \$10.4 billion (Rs.650 billion), or \$4.0 billion (Rs.250 billion) above the \$6.4 billion (Rs. 400 billion) budget deficit target. A revenue shortfall combined with excess expenditures is contributing to the larger than targeted fiscal deficit.

13. (SBU) According to the IMF, there will be a \$960 million (Rs.60 billion) shortfall in tax revenues, which have grown by 10 percent through July-January FY08 against the targeted 22 percent growth rate. General sales tax was the only category which recorded a significant growth of 15.78 percent. The income tax dipped by 4.55 percent, while customs duties increased at the marginal rate of 1.48 percent. Zero rating of the textile sector has led to tax leakages. In addition, the financial sector did not perform as well as it did last year, resulting in lower income tax collection.

Privatization program stalled

14. (SBU) Privatization proceeds budgeted at \$1.2 billion (Rs.75) billion are also likely to fall short, as no major privatizations are scheduled for FY08. The privatization proceeds stood at only \$133.2 million in July-January FY08. Following the Supreme Court ruling (under former Chief Justice Chaudhry) to reverse the Steel Mill privatization, the entire program came to a halt. The GOP

floated global depository receipts (GDRs) for a number of public sector companies (e.g. Pakistan Telecommunication Company before privatization, Oil and Gas Development Authority) in the international equity markets as a substitute for direct ownership transfer. In FY07 Pakistan earned \$1.37 billion from capital market transactions, including global depository receipts of Oil and Gas Development Company Ltd. and United Bank Ltd. and other public offerings of public sector enterprises. These transactions were a significant source of foreign exchange. The domestic political instability and rise in country risk have made GDRs less attractive to both domestic and foreign investors. As a result, the GOP opted to wait and has not floated any GDRs during the last six months.

But non-tax revenues likely to meet targets

15. (SBU) Fortunately, non-tax revenues are likely to meet their targets. The GOP budgeted \$370 million (Rs.23.17 billion) for coalition support fund reimbursements, rather than the \$1.28 billion budgeted (Rs.80 billion) in the previous fiscal year. Given the reimbursements already dispersed this year, and those in the pipeline; this target is likely to be met. However, the loss of two hundred million dollars for budgetary support does contribute to the GOP fiscal deficit. As a result, the Ministry of Finance is encouraging the Embassy to assume projects already budgeted rather than designing new projects. In other non-tax revenue items, the GOP has budgeted State Bank profits at \$960 million (Rs.60 billion), and dividends from public enterprises at \$1.25 billion (Rs.78.7 billion). The State Bank has already contributed \$752 million to the GOP exchequer to finance the budget deficit in the first quarter of FY08.

Increased energy, food subsidies contribute

ISLAMABAD 00001035 002 OF 002

16. (SBU) Expenditures are exceeding their target due to increased spending on energy and now food subsidies. According to the IMF, prior to the March 1 fuel price increases, oil subsidies ran at 1.5 percent of GDP, or close to \$2.4 billion (Rs.150 billion). According to the GOP, oil subsidies are \$2.17 billion (Rs.136 billion). We note that there is a discrepancy between GOP and the IMF estimates of oil subsidies. Our calculations show that the GOP will save only \$197 million after fuel price increases through the June 2008 end of the current fiscal year. The full cost of these subsidies is not reflected in the GOP budget statistics since the oil marketing companies effectively finance a portion of the fuel subsidies. The GOP regularly delays payments to the oil marketing companies. According to the IMF, the oil marketing companies have taken out short-term loans amounting to \$800-960 million (Rs.50-60 billion) from commercial banks to finance new fuel purchases. The GOP has not accounted for this money in the budget, but has provided sovereign guarantees to the commercial banks for the full amount of the loans.

GOP borrowing from the State Bank sets new records

17. (SBU) GOP borrowing from the State Bank of Pakistan (SBP) are already at record levels with four months of the fiscal year remaining. The half percent increase in the cut off yield for treasury bills and the rise in the discount rate to 10.5 percent have not reduced GOP bank borrowings. Despite resistance from the State Bank governor, the GOP is continuing to depend on the SBP to finance its fiscal deficit. Government borrowing from the State Bank of Pakistan to finance the budget stood at \$3.79 billion (Rs.237.1 billion) for July-January FY08 versus \$1.13 billion (Rs.70.9 billion) for the same period last year. The below-target performance from tax revenues and privatizations, combined with larger than targeted expenditures have left the GOP with few options other than borrowing from the State Bank of Pakistan. In addition to oil subsidies, wheat subsidies are also likely to influence the fiscal deficit. The GOP has imported wheat amounting to \$208 million in July-January FY08. Since September 2007, the GOP has placed orders for the purchase of 1.7 MMT of wheat valued at \$801.5 million. The

estimated government subsidy on this imported wheat is \$480 million.

Comment

18. (SBU) Pakistan has established a solid macroeconomic framework in the last five to eight years, taking advantage of political stability, good policy choices, a successful privatization program, and growing exports. The global environment was also congenial to emerging economies. A new government, high international commodity prices, an economic slow down in Pakistan's biggest export market, and decreased international liquidity will test whether Pakistan can preserve its good macroeconomic fundamentals. So far, the economy has shown resilience in the face of both domestic and external shocks, indicating the underlying strength of the economy. Despite the increases in international commodity prices and the GOP's recent decision to begin to pass them along to consumers, growth is still forecast to reach a respectable 5-6 percent this year. However, we do not believe that this growth is necessarily sustainable, given high subsidies to the domestic sector, continued low rates for tax collection, and the growing fiscal deficit. The rise in the fiscal deficit is likely to raise Pakistan's country risk and may lead to further downgrades in its ranking by international credit rating agencies. This in turn may reduce foreign inflows, especially the FDI inflows and adversely affect GDP growth. End comment.

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